

48-SBE-034

In the Matter of the Appeal of)
HENRY G. FENTON)

Appearances:

For Appellant: Raymon d M. Wansley, Attorney
at Law

For Respondent: W. M. Walsh, Assistant
Franchise Tax Commissioner;
Milton A. Huot, Assistant
Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 18593 of the Revenue and Taxation Code (formerly Section 19 of the Personal Income Tax Act) from the action of the Franchise Tax Commissioner on the protests of Henry G. Fenton to proposed assessments of additional personal income tax in the amounts of \$151.00 and \$3,919.18 for the years 1938 and 1939, respectively.

Although the proposed assessments reflect several adjustments made by the Commissioner in the determination of Appellant's net income, only that relating to the taxability to him of the income of certain trusts is contested by Appellant. The income in question is that of two irrevocable trusts established by Appellant and Emily B. Fenton, his wife, with property apparently considered to be Appellant's separate property. . The first (hereinafter referred to as the Fenton Trust) was created on November 26, 1935, and the second (hereinafter called the Hunte Trust) on December 28, 1936.

Mrs. Fenton and the trustors' married, adult daughter, Mrs. Emily Fenton Hunte, are named the beneficiaries of the Fenton Trust. Appellant is made the sole trustee, with provision that upon his death prior to the termination of the trust, he shall be succeeded by Charles C. Crouch, Chester O. Oline and Frank A. Riehle. The corpus consists of a one-half interest in a ranch (the other half being owned by Appellant individually and the entire ranch being under his management), and some shares of stock in the Western Salt Company, 55% of whose outstanding shares is owned by Appellant individually. He is also the president of that organization and in apparent control of all its outstanding shares.

Under the terms of the trust declaration the trustee (herein used both singularly and plurally) may sell, mortgage, exchange, convey or otherwise deal with or dispose of the trust estate as he may deem advisable. He may, if he is Appellant, invest the

Appeal of Henry G. Fenton

principal in any kind of property, "whether or not permissible by law as investment for trust funds;" if anyone other than Appellant, he may invest only in securities eligible for trust fund investment. He may determine what is principal and what gross or distributable net income, and has the same voting and other rights relative to the stock and other securities of the trust as might any owner thereof, but without any personal liability with respect thereto. All discretions conferred are stated to be "absolute and uncontrolled." Finally, the trustee is not limited to the powers and discretions enumerated, but is vested, in addition, in the execution of the trust with "all the powers and discretions that an absolute owner of property has or may have,"

Three-fourths of the net income of the Fenton Trust is to be paid over to Mrs. Fenton during her lifetime, and one-fourth to Mrs. Hunte for the duration of her life. Should Mrs. Hunte die leaving surviving children, Mrs. Hunte's share of the income is to go to the children until the termination of the trust (no later than the death of the last survivor of Appellant, Mrs. Fenton and Mrs. Hunte), upon which the principal is to be distributed to them. If Mrs. Hunte predeceases her mother and is not survived by children, Mrs. Fenton is to get the entire income. If both Mrs. Fenton and Mrs. Hunte predecease Appellant, and Mrs. Hunte leaves no surviving children, the principal and accumulated income are to be distributed in accordance with a power of appointment exercised by will by the last survivor of Mrs. Fenton and Mrs. Hunte. In the absence of such exercise, the property is to pass in the estate of the survivor according to the laws of succession.

Emily Fenton Hunte is the sole beneficiary of the Hunte Trust, and the trustees thereof are Messrs. Crouch, Oline and Riehle. The corpus consists of 150 shares of Western Salt Company stock originally issued in Appellant's name on December 28, 1936 (the date of the trust declaration); plus 750 shares of the stock of the H. G. Fenton Material Co., also originally issued in Appellant's name on December 28, 1936, this organization likewise being a corporation controlled by Appellant. All such stock was transferred to the Hunte Trust expressly subject to a prior pledge by Appellant to the Western Salt Company to secure the payment of a promissory note executed on December 28, 1936 by Appellant in the Company's favor in the sum of \$50,000, in consideration of a loan to him by the Company in that amount on the same day.

The trustees under the Hunte Trust are vested with powers substantially similar to those given the trustee or trustees by the instrument creating the Fenton Trust. One difference, however, is a provision in the Hunte Trust declaration whereby the trustees must obtain the approval of Mrs. Fenton and Mrs. Hunte before disposing of any trust property. Provisions relating to the payment of the net income received by the Hunte Trust are also substantially the same as those respecting the income of the Fenton Trust. The principal variation is in the

Appeal of Henry G. Fenton.

payment of the entire net income of the Hunte Trust to Mrs. Hunte.

None of the income from either trust was ever used for the personal purposes of Appellant, whether in discharge of his legal obligation to support Mrs. Fenton or any other purpose.

The Commissioner's action in this matter appears to have been prompted by the thought that, notwithstanding the legal effectiveness of the trusts, Appellant retained such control over the trust properties and the income thereof as to render himself subject to tax on the income in his personal capacity under the rule of Helvering v. Clifford, 309 U.S. 331. As evidence of such control, the Commissioner refers particularly, in the case of the Fenton Trust, to the powers vested in the trustee, to Appellant's majority ownership of the Western Salt Company stock, his presidency of the Company, and his one-half ownership of the ranch and his management thereof. As regards the Hunte Trust, he refers again to Appellant's stock ownership and control of the Western Salt Company, and also to his control of the H. G. Fenton Material Co., alleging that such ownership and control enable Appellant to determine the income payable to the trust, and to extinguish the trust by foreclosing upon the note executed to Western Salt Company and subsequently exhausting the security given therefor.

We believe, however, that the Commissioner's position is not warranted by the evidence and the pertinent authorities,

The United States Supreme Court held in Helvering v. Clifford supra, that the technical niceties of the law of trusts will be ignored to the extent of treating a trustor-trustee of a family trust as the owner of the corpus in his individual capacity for the purposes of Section 22(a) of the Federal Internal Revenue Code, if it appears that despite the creation of the trust he has not in fact relinquished his economic dominion and control over the trust principal. Section 22(n), which is substantially the same as Section 7(a) of the California Personal Income Tax Act (now Section 17101 of the California Revenue and Taxation Code), provides that "gross income" includes "gains, profits, and income . . . growing out of the ownership or use of or interest in . . . property . . ." It was found in the Clifford case that the trustor-trustee there involved remained in substance the owner of the corpus because (1) the trust, being for five years, was of short duration; (2) the corpus would revert to the trustor on the termination of the trust; (3) the trustor's dependent wife was the beneficiary; and (4) broad powers of management and control were vested in the trustor in his capacity as trustee. The Court stated

" . . . We have at best a temporary reallocation of income within an intimate family group. Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position." 309 U.S. at 335.

Appeal of Henry G. Fenton

The Court went on to say that "no one fact is normally decisive but that all considerations and circumstances of the kind we have mentioned are relevant to the question of ownership and are appropriate foundations for findings on that issue." 309 U.S. at 336. In addition, after noting that the issue as to the taxation of the trust income to the trustor Under Section 22(a) of the Internal Revenue Code is whether the trustor "may still be treated as the owner of the corpus," the Court further said

"...In absence of more precise standards supplied by statute or appropriate regulations, answer to that question must depend on an analysis of the terms of the trust and all the circumstances attendant on its creation and operation." 309 U.S. at 334.

We find on our reading of the authorities that the mere vesting, as here in the Fenton Trust, of conventional powers of trust management and control in a trustor-trustee in order to enable him to function to the advantage and for the best interests of the trust will not alone support a finding of retained control for the trustor's individual benefit of a kind sufficient to bring the case within the Clifford Rule. Jones v. Morris, 122 Fed. 2d 6; Armstrong v. Commissioner, 143 Fed. 2d 700; Hall v. Commissioner, 150 Fed. 2d 304; United States v. Morss, 159 Fed. 2d 142. As stated by Nossaman in his work entitled "Trust Administration and Taxation," Vol. 2, Sec. 646, pages 149-150:

"It seems clear, however, that the fact that the grantor is also trustee or may remove and appoint trustees or retains broad power of management does not, independently of other circumstances render him liable for the tax on the income. Such reservations are consistent with bona fide trust arrangements."

We find, also, that it has been consistently held that mere voting and business control of the type here present in respect to the Fenton Trust will not, apart from anything else, be deemed determinative of the question whether a case is within the Clifford Rule. There can be no doubt that it is a relevant circumstance and should be considered, but it is by no means controlling and is simply to be weighed in conjunction with all other factors bearing on the issue. Kohnstamm v. Pedrick, 153 Fed. 2d 506; Cushman v. Commissioner, 153 Fed. 2d 510; United States v. Morss, 159 Fed. 2d 142; Funsten v. Commissioner, 148 Fed. 2d 805; Miller v. Commissioner, 147 Fed. 2d 189; Edison v. Commissioner, 148 Fed. 2d 810, cert. den. 326 U.S. 721; Chertoff v. Commissioner, 160 Fed. 2d 691; Shapiro v. Commissioner, 165 Fed. 2d 811. Moreover, as stated in Cushman v. Commissioner, supra, at page 514, "the power to vote the stock held in trust may not be exercised by the trustee for his own purposes. .."

In the Miller, Edison and Funsten cases, supra, the Clifford

Appeal of Henry G. Fenton

Rule was applied in each to subject the trustor to tax on the trust income on the basis of a combination of circumstances which included voting or business control, trustee powers of a broad and unconventional character, and a power so to control the disposition of the income, either by an express provision for its withholding or accumulation or specific authority to shift it to another than the primary beneficiary, that the latter might never enjoy it during his lifetime. A similar, or nearly similar, combination will be found in almost all the cases in which voting or business control, along with other factors, has apparently been of some importance in leading to the conclusion that the trust income involved was taxable to the trustor under the Clifford Doctrine.

Aside from mere voting and business control, we fail to find any factors in the Fenton Trust which might serve as a basis for the Commissioner's position. Completely absent are any expressly reserved powers to control the disposition of the income and trustee powers of other than the customary kind. So also is any evidence that Appellant has used his voting or business control to withhold the payment to the trust of income to which it is entitled. We are unable, accordingly, to agree with the Commissioner that the income is taxable to Appellant under the rule of Helvering v. Clifford..

As for the Iiunte Trust, much of the foregoing discussion with reference to voting and business control also justifies the conclusion that the income is not taxable to Appellant under the Clifford Rule. Although not clearly brought out in the briefs, it would seem that the issue involved is not so much whether that principle is applicable as whether the case falls within the scope of Section 12(g) of the Act (now Section 18171 of the Code), which provides that where the title to any part of the corpus of a trust may at any time revert in the grantor without the consent of any person having a substantial adverse interest in any part of the corpus or the income therefrom, the income of such part of the trust shall be included in computing the income of the trustor. We do not believe, however, that this Section is applicable for the reason that we cannot see how the trust corpus can possibly revert in Appellant except through a sequence of events originating with a failure on his part to pay the note for which, the trust corpus is pledged and a terminal acquisition of the corpus by him either at a foreclosure sale or on its distribution or sale to him by the corporation at some later date, assuming, of course, that the corporation itself purchases the corpus at a foreclosure sale. If there should be any extinguishment of the trust through foreclosure of the trustee's stock, "this will be attributable, not to any powers of control reserved by the grantor, but to the fact that the trust res at the time of . . . /the/ creation /of the trust/ was subject to the infirmity that an outstanding pledge interest was held by third persons.?" Commissioner v. Branch, 114 Fed. 2d 985, 988.

Appeal of Henry G. Fenton

O R D E R

Pursuant to the views of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 18595 of the Revenue and Taxation Code, that the action of Chas. J. McColgan, Franchise Tax Commissioner, on the protests of Henry G. Fenton to the proposed assessments of additional personal income tax in the amounts of \$151.00 and \$3,919.18 for the calendar years 1938 and **1939**, respectively, be and the same is hereby modified; the action of the Commissioner in including in the gross income of said Henry G. Fenton the income from certain trusts is hereby reversed; in all other respects the action of the Commissioner is hereby sustained.

Done at Sacramento, California, this 15th day of December, **1948**, by the State Board of Equalization.

Wm. G. Bonelli, Chairman
J. L. Seawell, Member
J. H. Quinn, Member
George R. Reilly, Member
Thomas H. Kuchel, Member

ATTEST: Dixwell L. Pierce, Secretary